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SPECIAL REPORT

Tax Expenditures: A Critical Appraisal

by Dr. Norman B. Ture

This Special Report *contains excerpts from a recent study of tax expenditures that was published by the Savers & Investors Foundation.[1] The study's author, Dr. Norman B. Ture, clearly makes the point that U.S. budget policy is troubled enough in this time of persistent deficits without the use of misstated and mismeasured tax expenditures. We present this* Special Report *to our readers because it offers a thoughtful, critical analysis of an issue that affects U.S. tax and budget policy.*

Identifying the nature and magnitude of the influences that government activities and policies exert on economic activity is essential for good budget and tax policy. Although identifying and measuring "tax expenditures," as tax provisions that are believed to have the same effects as government outlays, is appealing in the abstract, in practice the identification and measurement of tax expenditures are seriously flawed. These limitations are so severe that the desirability of continued listing of tax expenditures in the federal budget should be subjected to the closest scrutiny.

CONCEPTUAL DEFICIENCIES OF TAX EXPENDITURES

The Congressional Budget Act of 1974, which mandates their inclusion in the federal budget, defines tax expenditures as "... revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." The current budget treats tax expenditures as essentially the same as "tax subsidies."

A meaningful and operational concept of tax expenditures requires:

- a clearly and completely specified set of tax laws that delineate a "correct" tax system, in order to determine whether any provisions of the actual law afford special exclusions, exemptions, etc., resulting in revenue losses;
- feasible techniques for correctly measuring the revenue losses resulting from tax expenditures; and
- conceptually acceptable means for identifying and measuring government outlays to which the tax expenditures are equivalent.

Problems in Defining the "Correct" Income Tax

The Budget Act of 1974 does not specify the tax laws that provide the standard against which any provision of the actual tax law should be judged to determine whether it should be identified as a tax expenditure. Since 1982, the budget document has identified tax expenditures as "... deviations from general rules that could be compared to the subsidy and transfer programs on the outlay side of the budget...." The "general rules" are those of a so-called "reference tax law," itself often ambiguous, arbitrary, and judgmental. The "reference tax" standard does not afford a rigorous definition of taxable income that is needed to identify tax provisions that may be characterized as special or as tax expenditures because they do not conform with this definition.

The Neutrality Criterion

The definition of taxable income that is needed to identify tax expenditures must be derived from the application of the tax neutrality criterion. Neutrality would provide a straightforward, conceptually consistent delineation of the required features of the "correct" income tax to be used in identifying provisions of the actual tax law that do not conform, hence may be identified as tax expenditures.

A neutral tax system is one that would not alter the relative prices and costs of goods, services, and activities that would prevail in an efficiently functioning private market, i.e., a market the results of which are not influenced by government actions or policies. The neutrality criterion calls for a tax that changes in the same proportion the costs and prices of all alternatives confronting taxpayers.

The neutrality criterion is essential if tax expenditures are to be identified as tax subsidies. A subsidy reduces the cost

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[1]Norman B. Ture, *Tax Expenditures: A Critical Appraisal* (Centreville, Virginia: Savers & Investors Foundation, 1990). For copies of the complete report, contact Suzanne K. Moreland, vice president, Savers & Investors League, 14200 F Centreville Square, Suite 175, Centreville, Virginia 22020; phone: (703) 815-3959, fax: (703) 815-3960.

or the price of the subsidized product, service, or activity below the level that would prevail in a market unaffected by government policies or activities. A neutral tax system would include no provisions that provide subsidies nor would it contain any provisions that differentially raise the price or cost of any product, service, or activity.

Tax Expenditures at Odds with Neutrality

Tax neutrality considerations would dictate a list of tax expenditures quite different from that presented in the federal budget. Many of the principal tax expenditures on the budget list are provisions that moderate the tax bias against saving and in favor of current consumption uses of current income. A tax expenditure list based on neutrality considerations would not show those provisions as tax subsidies. On the contrary, such a list would show the provisions of the tax law that exert an anti-saving bias as *negative* tax subsidies, i.e., as special tax penalties.

It is widely recognized that the income tax is inherently biased against saving and in favor of current consumption. While both consumption and saving come from after-tax income, disposable income that is used for current consumption is not again subject to the income tax, but income that is earned by current saving *is*. Taxing both saving and its returns raises the cost of saving compared with the cost of current consumption.

If the income tax is to be neutral in regard to saving vs. consumption uses of income, it must either allow the deduction of current saving while taxing all the returns on that saving, or it must tax all current income, including that which is saved, but exclude from tax all of the returns on the saving. The present income tax affords neither sort of treatment as a general rule; it does, however, provide some limited exclusions of income that is saved under retirement saving plans and does exempt from tax the interest earned on certain state and local government indebtedness. Provisions that embody either approach should be identified as moves *toward*, not away from, tax neutrality.

The budget listing of tax expenditures disregards the neutrality criterion. Among the largest tax expenditures in that list are provisions that moderate the anti-saving income tax bias, including the exclusion of employer contributions to pension plans and the earnings of such plans, the exclusion of interest on life insurance saving, and the exclusion of contributions to IRA plans and the earnings of these plans.

Also included are corporate income tax rates less than the 34 percent rate that applies to all of the income of a corporation if the corporation's income exceeds $335,000. It is difficult to perceive any justification for identifying these graduated rates as a tax expenditure. The corporate income tax itself is an extra layer of tax on the saving committed by individuals to ownership of equity interests in corporations. No provision that eases this extra tax burden should be treated as a tax expenditure.

PROBLEMS IN MEASURING TAX EXPENDITURES

Both technical and conceptual problems beset the measurement of tax expenditures. As indicated in the budget, the measurement of tax expenditures involves two steps. The first step is to measure the revenue loss of the tax provision identified as a tax expenditure. The revenue loss is then adjusted to an outlay equivalent.

Both measurements are conceptually fragile and grossly misleading. The revenue estimates themselves suffer from severe conceptual limitations, and the translation of these revenue losses into outlay equivalents also confronts formidable conceptual obstacles. . . .

CONCLUSIONS

The evaluation of the budget presentation of tax expenditures must rest on whether the listing serves a useful purpose of budget policy.

The appropriate purpose for listing tax expenditures, *assuming they were properly identified and measured*, would be to provide a fuller and more accurate delineation of the impact of government activities in claiming production resources, in directing their use, or in allocating the income claims generated by their use. For this purpose, however, the listing that is required would show not only those tax provisions that afford subsidies but those that differentially penalize affected activities, as well.

To serve this purpose, both the present basis for identifying "special" tax provisions and the methods for estimating their revenue effects would have to be drastically revised. The appropriate baseline tax would have to be spelled out in conformity with the dictates of tax neutrality, and the estimate of the revenue effects would have to be derived by taking as full account as possible of the dynamic responses throughout the economy to the provisions that are determined to be special. Some means would have to be found to identify the subsidy or differential penalty effect on costs and prices and to translate them into revenue effects and outlay equivalents.

Each of these requirements would confront formidable difficulties. If these requirements are not met, however, serious consideration should be given to repeal of the statutory provision requiring the inclusion of the tax expenditure listing in the budget.

The present tax expenditure listing misinforms those who inspect it, both in the identification of provisions deemed to be tax expenditures and in the magnitude of the revenue losses and outlay equivalents they entail. It should have no place, therefore, in the formulation of budget or tax policy.

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